Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:BRK:TL-N-2785-00
AJMandell

date:

to: Chief, Examination Division, Brooklyn
Attn: Group Manager, Irving Abidor
Group 1026, Garden City

from: District Counsel, Brooklyn

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subject: [redacted]

U.I.L. 707.01-00; 722.00-00

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ISSUE 1: Whether the taxpayer should recognize gain on the transfer of property to a limited partnership?[1]

(a) Whether the taxpayer should recognize gain as a result of the UPREIT's assumption of the indebtedness encumbering the property?

(b) Whether the contribution of the property in exchange for the UPREIT units constitutes a disguised sale pursuant to section 707?[2]

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[1]Whether the taxpayer should recognize gain on the transfer of the property is dependent on the sub issues listed below.

[2]After discussing the facts of the case with the National Office, it was decided that this memorandum would be sent to your office to obtain additional facts, and as will be discussed below, a request for field service advice would be sent to the National Office on the issues of whether the taxpayer's right to "put" their UPREIT units should be viewed as separate property distinct from the UPREIT partnership interest and whether the

(c) This opinion is based upon the facts set forth herein. You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

Whether the partnership's assumption of the taxpayer's liability should be treated as a distribution of sale proceeds for purposes of the disguised sale rules?

Facts:

The facts, as we understand them from the information you provided, are as follows[3]:

[redacted] ([redacted]) owned real property with an unencumbered fair market value of $[redacted]. The property is subject to indebtedness in the principal amount of $[redacted] and accrued but unpaid interest in the amount of $[redacted]. The debt was incurred on [redacted] and was not incurred in anticipation of the contribution. The basis of the property is approximately $[redacted].

[redacted] ([redacted]), a Maryland corporation, entered into a contract (the contribution agreement) with [redacted] to acquire the property. Pursuant to the contribution agreement [redacted] assigned its rights and obligations to [redacted], a limited partnership formed under the Delaware Revised Limited Partnership Act (the UPREIT). In exchange for [redacted]'s contribution of the property to the UPREIT, the UPREIT took the property subject to the indebtedness encumbering the property and distributed to the [redacted] partners UPREIT units with an aggregate value equal to $[redacted] less the amount of prorations and other amounts chargeable to [redacted] under the contribution agreement. The contribution agreement provided [redacted] with an option to reduce the number of UPREIT units its partners received in the exchange and compel the UPREIT to pay certain closing costs.

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transfer of property from the partnership to the partner is dependent on the entrepreneurial risks of partnership operations.

[3]All of the facts were taken from a legal opinion provided for the taxpayer by [redacted] and are not necessarily presumed to be correct.

Each UPREIT unit had a deemed value equal to one share of [redacted] stock valued at the weighted average closing price of [redacted] shares on the ten trading days immediately preceding but excluding the date that is five trading days prior to the date the property was contributed to the UPREIT.

As holders of the UPREIT units, the [redacted] partners were to receive the same distributions per unit as other holders of UPREIT units. None of the distributions to the [redacted] partners was to be funded by indebtedness as to which an UPREIT partner had the risk of loss.

Commencing on the later of the first anniversary of the closing and the date on which a registration statement filed in respect of UPREIT units issued to the [redacted] partners is declared effective, the [redacted] partners may present their UPREIT units for redemption for shares of [redacted] common stock or, at [redacted]'s option as the sole general partner of the UPREIT, cash or a combination of cash and shares.

It is the taxpayer's position that neither [redacted] nor the [redacted] partners will recognize gain on the contribution of the property to the UPREIT in exchange for the UPREIT units and a right to 'put' those UPREIT units to the UPREIT in exchange for [redacted] shares. The taxpayer believes that the [redacted] partners will recognize gain on the exchange of their UPREIT units for [redacted] shares.

Discussion:

ISSUE 1. Whether the taxpayer should recognize gain as a result of the UPREIT's assumption of the indebtedness encumbering the property?

(a) Whether the taxpayer should recognize gain as a result of the UPREIT's assumption of the indebtedness encumbering the property?

Pursuant to I.R.C. section 705, the adjusted basis of a partnership's interest in a partnership shall be the basis of such interest determined under section 722 decreased (but not below zero) by partnership distributions as provided in section 733.

Section 722 provides that the basis of a partnership interest acquired by a contribution of property, including money, to the partnership shall by the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain

recognized under section 721(b) to the contributing partner at such time.

Section 731 provides that in the case of a distribution by a partnership to a partner gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. This rule reflects the Congressional intent to limit narrowly the area in which gain or loss is recognized upon a distribution so as to remove deterrents to property being moved in and out of partnerships as business reasons dictate. S. Rep. No. 1622, 83rd Cong., 2nd Sess. page 96 (1954).

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner or partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

If a partners' liabilities are both increasing and decreasing in the same transaction, offsetting the increases and decreases tends to limit recognition of gain, thereby giving effect to the Congressional intent. Consequently, in a distribution of encumbered property, the resulting liability adjustments will be treated as occurring simultaneously, rather than occurring in a particular order. Therefore, on a distribution of encumbered property, the amount of money considered distributed to a partner for purposes of section 731(a)(1) is the amount by which the decrease in the partner's share of the liabilities of the partnership under section 752(b) exceeds the increase in the partner's individual liabilities under section 752(a). Rev. Rul. 79-205, 1979-2 C.B. 255.

According to the taxpayer, the UPREIT partnership agreement contains a deficit restoration obligation which can have the economic effect of causing the [redacted] partners to be deemed to guarantee a certain amount of UPREIT debt. The UPREIT is assuming a debt of the taxpayer of approximately $[redacted]. If in fact the taxpayer's share of partnership liabilities is increased by $[redacted], then, pursuant to section 752(b), there would not be any deemed distribution to the taxpayer. When the property is

transferred to the UPREIT, the amount of money considered distributed to the taxpayer for purposes of section 731(a)(1) would be the difference between the amount that the taxpayer's liabilities are decreased, by reason of the transfer to the partnership, and the increase in the partner's individual liabilities under section 752(a).[4]

To the extent that the liability of the [redacted] partners that is being assumed by the UPREIT exceeds the liability that is being assumed by the [redacted] partners, there would be a deemed distribution to the [redacted] partners in that amount. Gain will then only be recognized to the extent that the deemed money distribution exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.

If you can confirm the taxpayer's adjusted basis in the partnership immediately before the distribution and the amount of partnership liability that is being assumed by the taxpayer, since we know the amount of the taxpayer's liability that is being assumed by the UPREIT, the Service can determine if there is any gain.

ISSUE 1(b) Whether the contribution of the property in exchange for the UPREIT units constitutes a disguised sale pursuant to section 707?

Pursuant to section 721, no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Section 721 does not apply to a transaction between a partnership and a partner not acting in his capacity as a partner since such a transaction is governed by section 707. Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. Treas. Reg. section 1.721-1(a).

Section 707(a)(1) provides that if a partner engages in a transaction with a partnership other than in his capacity as a

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[4]When the property is transferred to the UPREIT it appears that the taxpayer as a partner will be assuming at least some of the debt on the property.

member of such partnership, the transaction can be considered as occurring between the partnership and one who is not a partner.

A transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances the transfer of money or other consideration would not have been made but for the transfer of property and in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. Treas. Reg section 1.707-3(b)(1). The weight to be given each of the facts and circumstances will depend on the particular case. Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists. Treas. Reg. section 1.707-3(b)(2).

The regulations list a number of factors that tend to prove the existence of a sale including that the timing and amount of the subsequent transfer was determinable with reasonable certainty; that the transferor had a legally enforceable right to the subsequent transfer; that the partner's right to receive the consideration was secured in any manner; that any person was legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of consideration; that any person had loaned or agreed to loan the partnership the consideration required to enable the partnership to make the transfer; that the partnership had incurred debt to acquire the consideration necessary to permit it to make the transfer; that the partnership held money or other liquid assets, beyond the reasonable needs of the business, that were expected to be available to make the transfer; that partnership distributions, allocations, or control of partnership operations was designed to effect an exchange of the burdens and benefits of ownership of property; that the transfer of consideration by the partnership to the partner was disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and that the partner had no obligation to return or repay the consideration to the partnership. Treas. Reg. section 1.707-3(b)(2).

It appears that the taxpayer had a legally enforceable right to the transfer. If the right to "put" its UPREIT units is viewed as separate property distinct for the partnership interest, then it also appears that the timing and amount of the subsequent transfer was determinable with reasonable certainty. Please ask the

taxpayer for documentation or other information needed to determine if any of the other factors apply that would show whether the distribution was actually a sale.

If within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner, the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale. This two year presumption applies regardless of the order of the transfers. Treas. Reg. section 1.707-3(c).

In contrast, if the transfer of property by the partner to the partnership and the transfer of money or other consideration to the partner by the partnership take place more than two years apart, then the transfers are presumed to not constitute a sale of the property to the partnership, unless the facts and circumstances clearly establish that the transfers constitute a sale. Treas. Reg. section 1.707-3(d).

Because the "put" was apparently not exercised within two years of the transfer, if the taxpayer's right to "put" their UPREIT units is viewed as separate property distinct from its UPREIT partnership interest, then it appears that the transfer of property (the "put") back to the partner would have been made simultaneously. There would therefore be a presumption that the transfers constituted a sale. The issue of whether the "put" should be viewed as separate property therefore becomes an important factor in making a determination as to whether this should be considered a disguised sale.[5]

Rev. Rul. 69-265, 1969-1 C.B. 109 considered a similar issue in the context of a section 368(a)(1) reorganization. In a transaction intended to qualify as a reorganization under section 368(a)(1)(C), a second tier subsidiary (S2) proposed to acquire substantially all of the assets of an unrelated corporation (X) in exchange for voting convertible preferred stock of its parent (S1), a wholly owned subsidiary of P. The voting preferred stock of S1 was convertible into common stock of P at the election of the shareholders at any time after five years from the date of the reorganization.

In situation one of the ruling, the shareholders of S1 electing to convert would present their S1 stock directly to P, and P would then issue its voting common stock in exchange for the

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[5]Please keep in mind that we have requested field service advice on this issue.

stock of S1. This conversion right was found to constitute property in addition to voting stock because the P stock was not held by S1 and was not, therefore, subject to the claims of creditors of S1. The result was reached regarding situation one on the basis that the conversion right at issue "eliminates the risk of loss which necessarily follows equity ownership, [so that] it is clearly separate from the bundle of rights associated with ownership of S1." Gen. Couns. Mem. 37612 (July 21, 1978)[6].

In situation two of the ruling, S1 would receive, as a contribution to capital from P, the number of P shares necessary for the conversion, and the S1 shareholders electing to convert would present their stock to S1. The Service concluded that the exchange right was in essence a right to have the S1 stock redeemed for specific property of S1, which like the other assets of S1 is subject to creditors' claims, and that this right did not constitute property other than the S1 stock.[7]

With regard to [redacted], based on the facts set forth in the tax opinion, it appears that the [redacted] partners could present their UPREIT units for redemption for shares of [redacted] common stock, or at [redacted]'s option, cash or a combination of shares and cash. Based on the reasoning in the revenue ruling, it would appear that because the taxpayer would present its units directly to the UPREIT, if the FRA shares that could be redeemed were owned by the UPREIT then the right to redeem would not be considered separate property.

Please confirm that the shares of [redacted] stock were already owned by the UPREIT. For example, if, as in situation two of the revenue ruling, [redacted] contributed shares of its stock to the UPREIT as a contribution to capital and those were the shares that could be redeemed by the taxpayer, then the exchange might be seen as a right to have the [redacted] stock redeemed for specific property of the UPREIT which like other assets of the UPREIT would be subject to creditors' claims.

Nothwithstanding the presumption relating to transfers made within two years of each other, an operating cash flow distribution

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[6]Although the general counsel memorandum was ultimately revoked (See Gen. Couns. Mem. 38844 (April 27, 1982)), it appears that it was revoked only to the extent that it was inconsistent with situation two of the revenue ruling.

[7]An analysis of situation two of the revenue ruling found that the conclusion reached was not free from doubt, but the result was not found to be erroneous. Gen. Couns. Mem. 38844 (April 27, 1992).

is presumed not to be part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is a sale. Treas. Reg. section 1.707-4(b)(1).

One or more transfers of money by the partnership to a partner during a taxable year of the partnership are operating cash flow distributions to the extent that those transfers are not presumed to be guaranteed payments for capital, are not reasonable preferred returns, are not characterized by the parties as distributions to the partner acting in a capacity other than as a partner, and to the extent they do not exceed the product of the net cash flow of the partnership from operations for the year multiplied by the lesser of the partner's percentage interest in overall partnership profits for the life of the partnership.[8] Treas. Reg. section 1.707-4(b)(2).

The tax opinion provided by the taxpayer concludes that the distributions to the taxpayer qualify for this safe harbor. The tax opinion states that were the UPREIT to perform poorly in any given year, there is no assurance distributions would be made. Please request documentation to support the conclusions reached in the tax opinion on this issue.

The legislative history of section 707 lists a number of factors that indicate whether the partner is receiving the allocation in his capacity as a partner. Generally the most important factor is whether the payment is subject to an appreciable risk. An allocation and distribution that subject the partner to significant entrepreneurial risk as to both the amount and fact of payment generally should be recognized as a distributive share and a partnership distribution. An allocation and distribution close in time to the performance of services suggests a disguised fee. However, if the allocation is remote in time from the services, the risk of not receiving payment may increase. Transitory partner status, tax avoidance purposes and a

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[8]The net cash flow of the partnership from operations for a taxable year is an amount equal to the taxable income or loss of the partnership arising in the ordinary course of the partnership's business and investment activities, increased by tax exempt interest, depreciation, amortization, cost recovery allowances and other noncash charges deducted in determining such taxable income and decreased by principal payments made on partnership indebtedness; property replacement or contingency reserves actually established by the partnership; capital expenditures when made other than from reserves or from borrowing; and any other cash expenditures not deducted in determining such taxable income or loss.

small continuing profits interest relative to the allocation in question all indicate third party status. S.Prt. No. 169, Vol.I, 98th Cong., 2nd Sess. 226-228 (1984).

Whether the distribution is considered close in time will again be dependent on whether the right to "put" the shares is considered separate property. The tax opinion concludes that the subsequent transfer is dependent on the entrepreneurial risk of partnership operation, but admits that the facts and circumstance are somewhat ambiguous. Please attempt to clarify the facts including whether the value of the [redacted] shares will be directly tied to the value of the partnership property.

ISSUE 1(c) Whether the partnership's assumption of the taxpayer's liability should be treated as a distribution of sale proceeds for purposes of the disguised sale rules?

For purposes of the disguised sale rules, if a partnership assumes or takes property subject to a qualified liability[9], the partnership is treated as transferring consideration to the partner only to the extent provided in Treas. Reg. section 1.707-5(a)(5).[10]

The tax opinion concludes that since the indebtedness encumbering the property was incurred more than two years before the contribution and was not incurred in contemplation of the contribution, it is qualified debt. Therefore, according to the opinion, unless the taxpayer is viewed as receiving a distribution of other property from the UPREIT, the UPREIT's assumption of debt encumbering the property will not cause the contribution to be

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[9]Qualified liabilities include liabilities that are more than two years old; that were not incurred in anticipation of the contribution of the property to the partnership; that are allocable under the rules of Treas. Reg. section 1.163-8T to capital expenditures with respect to the property; or that were incurred in the ordinary course of the trade or business in which the property was used if all the assets of that business are transferred with the property; and if the liability is recourse liability, the amount of the liability does not exceed the fair market value of the transferred property at the time of the transfer.

[10]Treas. Reg. section 1.707-5(a)(5) provides that if a transfer of property by a partner to a partnership is not otherwise treated as part of a sale, the partnership's assumption of or taking subject to a qualified liability in connection with a transfer of property is not treated as part of a sale.

recharacterized as a disguised sale.

We again have not seen any documentation to support the conclusions reached in the tax opinion. If, based on the factors listed above, this was qualified debt, then it appears that the conclusion reached in the tax opinion on this issue would be accurate.

Conclusion

Before a determination is made on whether the taxpayer should recognize gain on the transfer of property to the limited partnership we would need the additional facts outlined above. As mentioned above the National Office will simultaneously be providing field service advice on the issues of whether the taxpayer's right to "put" their UPREIT units should be viewed as separate property distinct from the UPREIT partnership interest and whether the transfer of property from the partnership to the partner is dependent on the entrepreneurial risks of partnership operations.

This opinion is based upon the facts set forth herein. You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

If you have any additional questions, please call the undersigned at (516) 688-1701.

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